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Financial Markets

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Irving Trust

Irving Trust Company
One Wall Street
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Economic Research & Planning Division

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(Noon)

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The money and credit markets were jolted this past week by a much larger than expected increase in M1 accompanied also by stronger growth for M2 and M3 than the market had projected. Amid news that the economy was strengthening faster than anticipated, the money supply results disappointed a market that simply had gotten too far ahead of itself. As a result, the market is no longer "priced" for a Fed discount rate cut. What happens next?

Despite the relatively sharp movements in the price of money market instruments this past week, prospects for the rest of the year are for rather small changes in interest rates--particularly in comparison with what we have experienced over the past several years. The Fed will continue to let its policy be conditioned by the needs of the real economy even over the protestations of any particular monetary aggregate. In this regard Governor Preston Martin's statement clearly was intended to remove M1 from the close scrutiny to which the market has subjected it. (Governor Martin indicated that M1 was still affected by certain distortions making it unreliable.) Still, the Fed is not completely disregarding its monetary targets; it's just that these are entering into the policy picture in a much more complex way.

The Fed is being less monetarist because very monetarist procedures have yet to prove that they can foster recovery. Market participants clearly realize this. Indeed, this is why Chairman Volcker's statement that the economy seems to have more momentum than before is so damaging to market sentiment. An application of Newtonian economics (an economy in motion tends to stay in motion...) by the Chairman underscores the position that the economy needs no stimulation from an outside source (like interest rates) as long as it is moving ahead.

For now, M1 above target--due to a combination of errant seasonal factors and a continued lag in velocity growth--provides the Fed with ample cause to hold interest rates steady. But what if M1 should move inside its target? Would the Fed cut rates? Here, two cases can be isolated. In the first case, with a flagging economy, a fall in money growth would most likely be viewed as the result of a collapse in money demand that should be reacted to with lower rates. In the second case, with a strong economy, the Fed would likely not react with a cut in rates. With economic growth progressing, the Fed would be more likely to think in terms of velocity and turn its attention to the prospect that if velocity grows, the 1983 targets begin to look very generous instead of confining. Thus, the Fed would "desire" M1 at the target bottom and would likely resist interest rate cuts until M1 was well in hand, and supported by an M3 within target.

According to these scenarios, we only get a sharp Fed-led break in rates if the economy suddenly goes flat. Still, market participants will continue to be anxious and to look for opportunity. As we have seen in recent weeks, the markets can produce a fairly wide trading range even without outward signals from the Fed. This situation will persist over the coming months, until the Fed decides which way it must move rates: The Fed is following the economy and, less closely, the money supply; it's not leading anymore.

Robert A. Brusca

Irving Trust

Market Yields

	5/20/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	10.50%	10.50%	16.50%
Effective since	2/28/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	12.00
Federal Funds	8.63	8.25	13.50
Repurchase Agreements	8.50	8.25	11.75
U.S. Treasury Issues			
Bills			
3 months	8.43	8.30	11.90
6 months	8.70	8.49	12.39
1 year	8.96	8.69	12.79
Coupons			
2 years	9.58	9.28	13.47
4 years	9.98	9.68	13.59
7 years	10.39	10.11	13.56
10 years	10.48	10.20	13.48
Long Bond	10.64	10.36	13.14
Negotiable Certificates of Deposit-Secondary Market			
1 month	8.55	8.25	13.45
3 months	8.60	8.30	13.30
6 months	8.75	8.45	13.30
1 year	9.15	8.80	13.30
Banker's Acceptances			
1 month	8.46	8.26	13.40
3 months	8.63	8.37	13.30
6 months	8.79	8.46	13.25
Eurodollar Deposits			
1 month	8.94	8.69	14.50
2 months	9.00	8.75	14.44
3 months	9.13	8.81	14.38
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	8.51	8.26	12.20
1 month	8.56	8.42	13.07
3 months	8.68	8.41	13.35
Bank Holding Companies			
1 month	8.56	7.97	13.32
Dealer Placed:			
3 months	8.66	8.41	14.17
New AA Corporate Utility Bond	11.40	11.30	15.85
Tax Exempt			
6 month Project Notes	4.75	4.75	7.50
1 year AAA Bond	5.25	5.00	7.75
5 year AAA Bond	6.60	6.50	9.00
20 year AAA Bond	8.50	8.15	11.80

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

Cable Address:
"IrvingBank" Telex: I.T.T. 420268 • R.C.A. 232241
W.U.I. 62832 • French 82629